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Monthly Letter on
Economic Conditions Government Finance

1951

New York, January, 1951

General Business Conditions

THE country is moving more rapidly each month to make armament its principal business, and to subordinate civilian activity and the peacetime way of life as far as may be necessary. On December 16 President Truman proclaimed the existence of a national emergency, which had the legal effect of strengthening his executive powers but was even more a summons to all citizens to united effort and sacrifice. At the same time he appointed Charles E. Wilson, president of the General Electric Co., to head the new Office of Defense Mobilization. Mr. Wilson will direct and control both production and stabilization agencies. On the financial side, Congress was asked for, and promptly passed, defense appropriations totaling another $20 billion. This Congress has now appropriated more than $42 billion for defense, as compared with an original budget of $13.3 billion requested for the purpose a year ago.

These moves have been received with acclaim. In Mr. Wilson a leader known for his ability, devotion and forcefulness has been found. Beyond question people want to get ahead with the job. They want clearer guidance and more definite goals and policy. Whatever their differences of opinion otherwise, they want a procurement program commensurate with the gravity of the war danger. The industries want to be told what they are to do, and to get squared away for it. Up to this time the flow of orders and specifications has been slow, and only a minute percentage of the productive facilities of the country have been put on defense work, despite the fact that regulations limiting use of materials in civilian products are already numerous. The situation is not satisfactory from the viewpoint of national defense or in respect to the outlook for production and employment in the industries affected by materials shortages.

Now the pace of contract awards is being stepped up, and more rapid progress is expected. Of course this does not mean that new weapons will soon start flowing in quantity, or that transition problems will be avoided, for organization and tooling up require time. The General Motors automobile assembly plant in Kansas City, for example, will stop turning out automobiles and produce jet planes, but the changeover to such a radically different product necessitates plant rearrangement, new machinery, and retraining of workers. The example could be multiplied. Necessary delays and temporary disruption, however, can be borne with patience, if the country knows what the military needs are and can get to work on them.

The Shift of Resources

In basic terms, the task now faced, of which Mr. Wilson assumes direction, is to shift resources, including workers, materials and factories, from civilian to armament needs in whatever degree may be required. It would be more agreeable to everyone if the armament output could be supplied wholly by drawing new workers into the labor force, calling forth new pro-

CONTENTS

duction of metals and other materials, and erecting new factories and building new machinery. Something – in some cases a good deal – can be done in that direction. It is already plain, however, that even the wonderful resources of the United States, plus what other countries can send us, cannot supply at present all the materials that would be needed to avert curtailment of civilian output.

This prospect now dominates the outlook. The metal using industries, particularly those manufacturing consumers' durable goods, will have no choice but to shift operations because the national interest requires the use of part of their resources for a more urgent purpose. During the month further limitation orders covering zinc, nickel, tin and a few less prominent commodities have been added to the aluminum, copper and rubber orders previously issued. These orders so far have reduced civilian use by stated percentages applied to each user. They are now being, or soon will be, reenforced by orders prohibiting all use of the scarce materials in certain stated end-products.

Materials saved and workers released by civilian curtailment will make the armament production possible. The shift will not be easy for those affected, but both relatively and absolutely it will be less extensive than in 1941 and 1942, when the industries accomplished it far more smoothly than people had thought possible. It is certain that the appointment of Mr. Wilson will enhance confidence that the Government's part in the process will be wisely managed.

Stabilization Problems

The second part of Mr. Wilson's task will be the direction of economic stabilization policy, in which the difficulties are already apparent. For some weeks the country has been approaching a time of decision with respect to adoption of further anti-inflationary measures. In the early fall there seemed reason to hope that the inflationary pressures growing out of the upsurge of business and consumer spending after the Korean invasion were subsiding. Unfortunately, this hope has been disappointed. Wage increases have spread and industrial costs have risen. Rising personal incomes and expectation of shortages and higher prices have kept consumer buying active. Most business men appear to be ready to stock all they can get of scarce goods, which from the individual viewpoint is a wholly reasonable policy. Programs for plant and equipment expenditures have expanded. Regulations W and X restricting the use of credit for consumers' durable goods and housing, while having some effect in their special areas and promising to exert more influence as time goes on, have not offset the inflationary factors in the general situation. Prices have continued to rise, and during the past few weeks both the official wholesale price index and the consumers' (cost of living) price index of the Bureau of Labor Statistics have broken into new high ground, exceeding the 1948 peaks.

Few will dissent from the view that it is time for stronger anti-inflationary measures. A continuing rise in prices would add to the cost of living and to the cost of the armament effort, encourage hoarding, reduce the purchasing power of savings further, penalize the many people who do not have corresponding increases in income, and finally raise the general price level on stilts with a possible calamitous fall. Everyone who has saved anything or who lives on a relatively fixed income learned the lesson of the evils and illusions of inflation in the long years of the war and in 1946-48.

Price Controls Begin

In these circumstances the Government has turned for the first time to direct price controls. General Motors, Ford and Chrysler have been required to void price advances on their new model automobiles, and general "pricing standards", designed to prevent increases above December 1 prices except under specified conditions, have been issued.

The decision thus taken is a momentous one. It will be applauded by some and denounced by others, for there are all shades of opinion as to the share which price ceilings should have in an anti-inflationary program. From wartime experience people should remember their weaknesses as well as their virtues. The basic weakness is that price controls deal only with the symptoms of inflation and not with its causes. The causes are an excess of money, of incomes and of spending in relation to the supply of goods available in the markets. An excess of spending power is inherent in an armament program, for people are paid for producing things which they cannot buy and which for the most part they could not use if they could buy. The purchasing power comes into being, but the goods that under peacetime circumstances would absorb it pass into the hands of the Government. The only way to deal with inflation at its source is to absorb the excess of income through taxation, reduce the excess of spending by saving, and restrain the expansion of the money supply by appropriate monetary and credit policies.

Lessons of Experience

If stabilization policy strikes the inflationary menace at the source, direct price controls will work, but by the same token they will be largely unnecessary. If the inflation pressures are not eliminated at the source, price controls will not work very long or very effectively. This is the first lesson of the war and postwar experience. The controls were effective in retarding the rise of the price indexes, but much less so in holding down the real prices which people had to pay. Black markets appeared and absorbed increasing quantities of goods. Qualities deteriorated, and production was shifted from low priced to high priced lines. There is little reason to expect a different experience now if general and rigid price controls are reestablished without adequately strengthening other measures.

Rigid price controls deprive the economy of the guidance which free price fluctuations give to production and distribution. They disturb the freely changing relationships under which the economic system functions best, and turn trade and distribution away from normal efficient channels, with resulting loss and waste. All these effects can also be found in the wartime record. The economic system can endure a straitjacket for a time, but the effort on which the country is now engaged is not a sprint. On the contrary, it has no foreseeable end. The strength of the country is in its production, and the price system supplies both the incentive to make production great and the guidance to make it flexible.

Finally, people should remember that wartime price controls did not prevent inflation in the end, but only retarded and deferred it. The forces suppressed during the war had their effect after the price control system broke down and was abolished. The reason is simply that the excess purchasing power which was not spent during the war accumulated in the form of idle cash balances, government bonds, and other liquid assets. When the controls were dropped, this accumulation of liquid assets went to work. The price level moved up to correspond with the expansion of the money supply, and the result was the 1946-48 inflation.

Even this brief summary should demonstrate that moves against inflation must come not principally from price controls, but from all sides. The practicable objectives of price ceilings themselves are limited. They can usefully restrain price increases where higher prices would not be effective in increasing production. Applied to basic or semi-processed commodities of major importance in the cost of living or in industrial costs, they can do much to restrain increases in a multitude of finished goods, where control is less practicable. Against these assumed benefits, the weaknesses and outright bad effects are to be considered.

Views of Economists

In view of the limitations inherent in direct controls and the illusions and evils which seem inescapably to accompany their use, economists generally would assign to them only a secondary place in needed anti-inflationary policies. A noteworthy statement has been issued during the past month by a group of 220 economists representing 27 of the nation's colleges and universities. This statement, drafted by a group at Princeton University, puts anti-inflationary measures in their proper order and perspective. It advocates elimination or postponement of all government expenditures that are not urgent and essential. It urges raising taxes to achieve and maintain a cash surplus. It recommends restricting credit, both specifically and generally, for purposes not essential to the defense program. It accepts the need for allocation programs and orders limiting consumption of scarce materials to essential uses. It points out that "stability of the general level of prices would be impossible in the face of general wage increases that substantially raise costs and private spendable incomes".

As to direct controls, it says no more than that "voluntary restraints by business and labor are an important ingredient of a successful anti-inflation program, and if business and labor cannot or will not exercise such restraint some mandatory government ceilings may be necessary".

The purpose and effect of this statement is to say that fiscal and credit measures are the only adequate primary defense against inflation, and that in their absence "a prolonged decline in the purchasing power of the dollar would undermine the very foundations of our society (or) an ever-spreading system of direct controls could jeopardise our system of free enterprise and free collective bargaining".

Another notable statement has been issued by no less an authority than the Government's Wage Stabilization Board, which says:

> The stabilization of wages, salaries and other compensation, the primary concern of the Wage Stabilization Board, . . . will not by itself attack inflation at its sources, but will merely conceal and defer its effects, while permitting a pressure of hidden spending power to build up.

The measures advocated by the Board to make it possible for it to do its work effectively are essentially the same as those of the uni-

versity economists. In detail they include increased production, increased taxes, decreased non-military spending, wisdom in military spending, limitation of credit expansion, and encouragement of thrift and savings.

Price Moves to Date

The foregoing statements should explain why the price control steps taken during the past month can hardly be expected to accomplish much by themselves, and why business men are inclined to consider them ill-advised, confusing and largely punitive in intent. In selecting automobiles the price controllers applied their first order to an end-product, rather than to basic materials influencing the cost of end-products. They applied it to a product – a new automobile – whose price is of little importance in the cost of living, inasmuch as many families do not buy it at all and few much oftener than every three or four years, on the average. In this respect the order seems to run counter to the intention of the Defense Production Act, which specifies that if price increases are to be forbidden they must be such as to "materially affect the cost of living or the national defense".

The models on which prices were rolled back were new products. Their cost of production is and will be higher because of higher wages, higher materials prices and diminished output due to shortage of materials. Moreover, competitors of the three companies, which had introduced and priced their new models earlier, were allowed to retain their higher prices. The order is therefore inequitable. The final question is whether the consumer is really protected. According to the lesson of experience, the public if it wants the cars will pay the higher prices indirectly if not directly, which simply means that the middleman will get what is taken away from the producer.

The overall "pricing standards" to which reference was made earlier are vague and general in character. They say that prices prevailing on December 1 should not be raised by companies whose profits before taxes are equal to their 1946-49 average, except in the case of particular products or services not now profitable; prices of these may be increased to make them profitable or to cover the cost of the rise in wages and materials since the Korean invasion. Distributors are forbidden to increase their gross margins above the June 1950 level if their profits equal their 1946-49 average, and to raise prices on the basis of increases in replacement costs; in other words, they must add their margins only to the costs they actually pay.

These standards are so indefinite that business men with border line cases do not know how to apply them. The agency lacks an adequate staff to interpret them in the multitude of cases that will come up. They are tied in the main not to current costs but to profits in a base period now past, which freezes inequities and destroys flexibility. They penalize sellers who have operated on small margins and kept prices down. In many areas, particularly in certain basic raw materials markets, they are in practice inapplicable. When they will be supported by wage stabilization measures, which the Defense Production Act requires if prices are controlled, is uncertain. Hence the standards control prices, but not costs. They are regarded, to be sure, as an interim measure, and the agency has every right to demand and expect willing cooperation to make them effective. But with the best will to comply in the world, the standards illustrate the complexities and inequities encountered.

A Fundamental Difficulty

Another fundamental difficulty is the fact that every anti-inflationary measure is restrictive and unpalatable to some one. Those who do not like its effects upon themselves are easily persuaded that they are asked to carry a greater burden than someone else, and that they should have exceptions. The Act under which the present moves have been taken includes formulas which set minimum levels for ceilings on farm prices, and because of these restrictions there are only a few major agricultural commodities on which ceilings could now be placed. The Act also refers to "ceilings" on prices but only to "stabilization" of wages and other compensation, which leaves the way open for different definitions.

On December 20 labor union leaders (United Labor Policy Committee) stated formally to President Truman that "stabilization must not become freezing". It "must permit the adjustment of wage rates to compensate for increases in the cost of living". It "must provide for the correction of substandard wages and the adjustment of inequities". The principle "that wage earners should share in the benefits of . . . increases in productivity . . . should be specifically embodied". They advanced still other considerations, with which the Wage Stabilization Board will be compelled to wrestle.

All this properly raises a question. Where is the sacrifice to fall if all politically powerful groups protect themselves against sacrifice? The answer of course is that if all groups seek ex-

ceptions the inflationary pressures will not be contained, and all will suffer. No group can escape sacrifice except at the expense of others.

In conclusion, the pressing question now is whether the country is to rely chiefly on the sound and effective policy, set forth by the 220 economists and the Wage Stabilization Board, of attacking the causes of inflation, or on direct controls to suppress its symptoms. A good start has been made toward dealing with the causes. Taxes have been increased. The Treasury has been running a cash surplus most of the time and will do so for at least some months to come. Direct credit controls have been established, money policy firmed and bank reserve requirements raised. The physical side of the problem, such as allocations and limitations on use of materials, is in good hands. Perhaps the next need is for taxes designed to fall directly on consumption.

In any case, the line of attack which affords the best hope of a sound solution of the problem is through fiscal and money policy. There is no panacea for making anti-inflationary measures painless. The situation requires political courage, individual cooperation, and working and saving by everyone.

The Trade and Industrial Outlook

Under the conditions described the trade and industrial outlook for the coming year hardly requires the extended discussion which is customary at New Year's. Barring complete relaxation of the international tension, it seems as certain as anything can be that the industrial organization as a whole will be under pressure, markets for the most part will be tight, more workers will have to be drawn into the labor force, and purchasing power will be high. Total war is possible, which would negate all prophecy.

The period of transition, during which the shift of resources from peacetime work to armament production takes place, presents difficulties; but as time goes on the feeling is gaining ground that the special problems of the industries affected will not seriously depress the general situation. Since the chief depressing influence is shortage of metals, it should be realized that the shortages are relative to a record-breaking demand, and that in absolute terms supplies of scarce materials available for civilian use for some time to come promise to exceed the average amount consumed in a fairly good year such as 1949, although falling well short of 1950 use. In addition the increased amounts reserved for priority orders will help sustain activity.

As a general statement, it can be said that full utilization of available materials apart from what goes into government stockpiles will support during the transition period an overall volume of productive activity not much below recent levels. While plants making consumers' durable goods are curtailing, those producing armaments and industrial equipment will be expanding. Over the longer run the expansion will dominate.

In the trade outlook expectation of shortages and possibly higher prices keeps both consumers and business men in the mood to buy. Within the month the cotton goods markets and the shoe and leather trades have been stimulated unexpectedly by large government orders. Automobile markets have turned more active after a sluggish period, for the obvious reason that both dealers and consumers think the cars will prove to be good buys. Christmas trade has been good. By definition, an inflationary period is a time of active demand. Doubtless the demand would not be as good if buyers felt assurance that their future wants would be supplied. But in most lines that is not the situation.

Curbs on Credit

On December 29 the Federal Reserve Board announced increases in the legal reserve requirements for the 6,900 member banks of the Federal Reserve System as a further measure to curb credit. The increases amount to 2 per cent of demand deposits and 1 per cent of time deposits, and will require member banks to find $2 billion in cash and place it on deposit with the Federal Reserve Banks. The increases in requirements are spaced out over the period January 11 to February 1 and will be fully effective on the latter date.

Member Bank Reserve Requirements

	Previous Required Percentage	New Required Percentage	Amount Involved in Increases* (Millions)
On net demand deposits			
Central reserve city banks	22	24	$ 500
Reserve city banks	18	20	630
"Country" banks	12	14	540
On time deposits			
Central reserve city banks	5	6	30
Reserve city banks	5	6	120
"Country" banks	5	6	150
			$1,970

* Based on average deposit volumes prevailing in the second half of September, 1950.

This action on reserves makes it appropriate to review the measures that have been taken during the past year to apply restraints on credit expansion.

The Monetary-Fiscal Approach

Since last July it has been the stated policy of the Government to avoid comprehensive direct

controls so far as possible and to rely in major degree upon fiscal and credit measures to curb inflation. In recent weeks a machinery for direct controls has been in process of organization, allocation of scarce materials has been started, and in the automobile industry prices and wages have been stabilized by government order.

This turn of events might suggest that fiscal and credit measures will be superseded by a freeze on prices and wages and a rationing of available goods. But a system of general price controls, wage controls, and rationing—unless we are to accept totalitarianism as a way of life—can never be more than an emergency stopgap and in any event its success depends on balance between money and the goods to be bought, the province of monetary and fiscal policy.

A statement by the Committee for Economic Development on "Paying for Defense" has put the case very well:

> Experience in the United States and in other countries has demonstrated that this (a system of general price and wage controls and rationing) is not an effective solution to the inflation problem, especially if the problem lasts for a long time. Even while the controls are nominally in effect, price increases break through in black markets, in deterioration of quality, and in the disappearance of low-priced goods from the market. Price ceilings and wage rates come to be determined in a political bargaining process which pushes up the prices and incomes of the groups most powerful politically at the expense of those less powerful. And when the controls finally come to an end, either by formal decision or by erosion in fact, the dammed up inflationary pressure breaks out in open inflation. During the period when the inflation is suppressed the excess demand still has its damaging consequences. It reduces efficiency because business managers know they can sell whatever they can produce and workers have no fear of losing a job. The pattern of materials allocation becomes frozen so that new businesses cannot start and grow. Prices are prevented from performing their economic function of directing production and distribution and economizing the use of scarce resources.

The recommendation in the statement is to use what it calls the monetary-fiscal approach: taxation to reduce the incomes individuals and business have available to spend, credit controls to restrict expenditures financed by borrowed money, a program to promote savings, and maximum economy in government expenditure.

Credit Restrictions

Present efforts to make credit policy work must be considered against the background of government fostered easy-spending, easy-lending. It was only last spring that home-building on little or nothing down was being spurred by extensions of authority to the Veterans' Administration and the Federal Housing Authority to guarantee mortgages, and to the Federal National Mortgage Corporation ("Fannie May") to buy up more mortgages. At the same time banks, under public criticisms that they were not lending freely enough, intensified their efforts to find creditworthy loan applicants. Life insurance companies, savings banks, and building and loan associations were beating the bushes for mortgage business. Instalment credit houses and retailers were urging borrow-to-buy. Never in our history were more attractive inducements held out to people to go into debt. Thus, when the Korean war stimulated a splurge of anticipatory buying, every credit facility was available to accommodate it—plus liquid assets accumulated during World War II or laid aside for the postwar depression that never came.

The reversal of policy was not effectively implemented until September and October, though preliminary warnings were given out earlier. On July 19 the President, pointing to the dangers in credit expansion, asked federal housing agencies to slow up their activities. On August 18 the Federal Reserve Banks, concerned over the expansion in bank loans, took affirmative action, raised their discount rates and, over Treasury objections, turned their open market powers in the direction of restraint. On September 8 the Defense Production Act of 1950 was enacted, authorizing among other things control over the terms of real estate and consumer credit. On December 29 the Federal Reserve Board announced the $2 billion increase in reserve requirements.

Regulations X and W

Regulation X, covering extension of private credit for home-building, was announced by the Federal Reserve Board October 11 to become effective the next day. The Housing and Home Finance Agency Administrator, Mr. Raymond M. Foley, announced companion restrictions on government-aided housing finance. The regulations were designed to cut back home-building in 1951 about one-third below the recent record level, to restrict the flow of funds into the mortgage market, and to assure that materials and labor required for the defense program would be available when needed. The restrictions are applied by a formula that retains preferences for veterans and purchasers of low-cost housing. The down payment requirement, the most critical limitation imposed by the regulations, ranges from 5 per cent for a $5,000 house bought by a veteran to 50 per cent for a $25,000 house bought by a non-veteran. Consideration is being given to credit restrictions on apartment building.

This is a courageous program and will be effective in time. But while it was being hatched a huge amount of commitments were made to beat the gun. It will thus be many months before the regulation really reduces the amount of building. In the meantime mortgage credit continues to expand.

Regulation W, applying to consumer credit, was first made effective September 18 and substantially tightened effective October 16. For automobiles, the current regulations require a down payment of one-third, the balance to be paid over 15 months. On television sets and other major appliances the required down payment is one-fourth and the maximum term 15 months. For automobiles, the most important item, the requirements are similar to those in force in 1942-47, and during the fall and winter of 1948-49. The previous temporary authority to regulate consumer credit expired June 30, 1949.

The consumer credit regulations stirred strong protests, especially from auto dealers and unions. While these diminished as a strong demand appeared for the new 1951 models, it is certain that the regulation cut some marginal buyers out of the market. The recent strength of the markets for cars and appliances, stimulated by apprehensions of shortages, indicates that there are many people able to meet the present terms of purchase, or to buy outright with cash savings.

Another heavy source of credit demand, one about which nothing has been done, has been States and local governmental bodies, supplementing tax revenues to build highways, schools, and other public facilities. Borrowings of new money by States and municipalities ran up a new record in 1950, near \$3½ billion. Coming on top of borrowings of \$2.2 billion in 1947, \$2.6 billion in 1948, and \$2.8 billion in 1949, total indebtedness of State and local governments is now approaching \$25 billion. Prior to 1949, the total indebtedness had never exceeded \$20 billion.

Business Borrowings

Business borrowings also rose during 1950 to a new peak under the pressure for funds to extend capacity and to finance enlarged production, inventories and payrolls. Corporate bond flotations for new capital, the greater part originating with public utilities, exceeded \$3 billion but fell short of the \$5 billion raised by bond issues in 1948. Long-term capital requirements of more than \$10 billion were supplied by ploughing back profits. Another \$1 billion of equity capital was procured by common or preferred stock issues.

Business borrowings from banks, which are sensitive to working capital requirements of industry, increased in a record amount. For December 20, 1950, weekly reporting member banks had outstanding \$17.8 billion in commercial, industrial and agricultural loans, a rise of \$3.9 billion over the figure for December 28, 1949. This expansion followed a decline in 1949 which had broken a string of increases in 1946-48. In interpreting the figure it should be borne in mind that the resumption of private financing of the cotton supply probably accounted for around \$1 billion of the 1950 increase. A year ago the bulk of the nation's cotton was being carried by the Commodity Credit Corporation, either as the holder or the lender, and at the expense of the federal deficit. This year merchants and manufacturers, together with exporters, took up practically the whole of the new crop plus stocks previously financed by the C.C.C. and borrowed from their banks to do so.

The overall expansion in loans by reporting member banks, as the following table shows, reached \$6.3 billion through December 20, a record increase. The rise in business loans, \$3.9 billion, was larger than in 1947, the biggest previous year, while real estate loans, up \$0.9 billion, expanded a little less than in 1947. The \$1.4 billion increase in "other loans" reflects instalment purchases financed directly with banks, other personal borrowings, and also includes loans extended to the French and other foreign governments.

Annual Changes in Loans and Investments
Weekly Reporting Member Banks

(In Millions of Dollars)

	Dec. 20, 1950	Dec. 28, 1949	Dec. 29, 1948	Dec. 31, 1947
Business loans	\$+3,897	\$—1,673	\$+ 847	\$+3,304
Security loans	— 3	+ 205	+ 327	—1,058
Real estate loans	+ 912	+ 280	+ 590	+ 969
Loans to banks	+ 91	+ 78	+ 135	+ 34
Other loans	+1,435	+ 515	+ 438	+ 657
Total loans	+6,332	— 595	+2,337	+3,911
U. S. Government securities	—3,659	+4,482	—4,240	—3,826
Other securities	+1,366	+ 853	— 55	+ 276
Total loans and investments	+4,039	+4,740	—1,958	+ 361

Effect of Federal Reserve Open Market Operations

The point of attack on business borrowings has been via the Federal Reserve discount rate, raised from 1½ to 1¾ per cent late in August, and open market operations which, intermittently during the year, allowed prices of government securities to decline and yields to improve. One direct result was an increase of a quarter or one-half of one per cent in the cost of business borrowings for shorter periods of time. Another

was to take away the opportunity for banks to sell governments at a profit and shift to loans or other investments. In some cases, the decline in government securities put banks in a position where a loss on governments had to be absorbed if loans were to be expanded. Meanwhile the improvement in yields on government securities, though only ¼ per cent, measurably broadened the market for government securities outside the banks. For the first ten months of 1950, as the following table shows, there was an increase in holdings of U. S. government securities by nonbank investors of more than $4 billion.

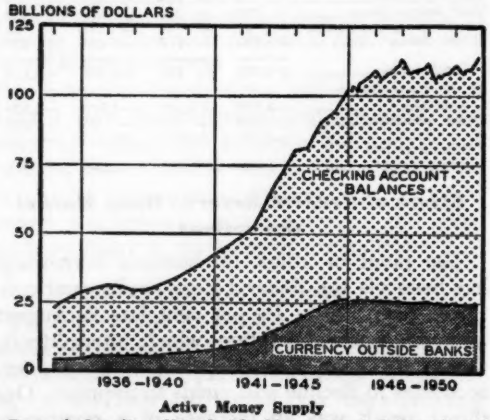
Shift in Ownership of U. S. Government Securities
January-October, 1950
(In Billions of Dollars)

	Holdings on 12/31/49	Holdings on 10/31/50	Changes over 10 months
Total interest-bearing debt*	$255.1	$254.8	—0.3
Held by government investment accounts	39.4	39.0	—0.4
Held by public	$215.7	$215.8	+0.1
Distribution of public holdings—			
Federal Reserve banks	$ 18.9	$ 19.3	+0.4
Commercial banks	66.8	62.3	—4.5
Nonbank investors	130.0	134.2	+4.2
	$215.7	$215.8	+0.1

* Including obligations guaranteed by the U. S. Government.

Source: Based on data of the Treasury Department and Federal Reserve Board.

With the substantially enlarged holdings of government securities by nonbank investors, and a federal budget close to a balance, the increase in active money supply (checking account deposits plus currency circulation) in the first ten months of 1950 was less than $3 billion. This put the total, as the chart indicates, up to a level of $114 billion, practically equivalent to the peak reached at the end of 1947. One test of monetary policy will be the ability to hold this figure down. The stability of the American economy cannot stand another big inflation in money supply – and in prices – on top of that experienced over the past decade.



Active Money Supply

Demand deposits adjusted (checking account balances) and currency outside banks.

Source: Board of Governors of the Federal Reserve System. Figures for July through October are preliminary.

Aside from the discount rate and open market actions, the Federal Reserve and other bank supervisory authorities issued appeals and warnings to the banks to screen their loans more carefully and persuade borrowers to limit their credit requirements. Early last month Thomas B. McCabe, chairman of the Federal Reserve Board, presented a new proposal to the National Credit Conference, held at Chicago under the auspices of the American Bankers Association, whereby financial institutions would enter into voluntary agreements, authorized by the Defense Production Act, to restrain the use of credit not needed for the defense effort. The proposal is under study and offers at least a hopeful framework for bringing lending policies of banks, insurance companies, and houses of issue under joint review by representatives of the lenders and the Reserve System.

The Reserve Requirement Increase

As the reserve requirement increase was announced, there was evidence in the market that the Federal Reserve Banks had again put pegs under the government security market to maintain their price levels. This recalls the situation prevailing in 1948 when the authorities successively raised reserve requirements and bought up government bonds in huge amounts at fixed prices and thus put the banks in funds to meet the requirements. It is worthy of note that, except for short-term paper, the pegs in the present case are higher than those in force during 1948.

In pegging the bond market, the authorities tacitly admit that reserve requirement increases are too roughshod a weapon and cannot safely be allowed to become fully effective. What effect is left, when pegs are put under the government bond market, is dubious. It does seem safe to expect that at least some scattered banks, where credit demands have reduced government security holdings to low levels, may be forced to cut back their loans. If their borrowers do not have other credit facilities open to them, credit will be reduced. The most likely casualty, thus, is apt to be a small business borrower with a single line of credit in a local bank.

For most of the banks, doubtless, the adjustment will be accomplished with the greatest mechanical facility. Government securities will be sold with the Federal Reserve the buyer. In effect, banks will ship a part of their government securities to the Federal Reserve where they will get a credit of idle, unusable cash. By and large,

the whole of the operation — increasing cash reserve requirements with one hand and supplying the cash with the other — is self-defeating. There is no escape from the principle, stated by Governor Eccles a year ago:

> In making a cheap money market for the Treasury, we cannot avoid making it for everybody. All monetary and credit restraints are gone under such conditions; the Federal Reserve becomes simply an engine of inflation.

The $2 billion reserve requirement increase was publicized as a step to tie up about $12 billion of "potential bank credit" because of "the repeated turnover of funds involved in bank credit transactions." It is true that the larger the proportion of their resources banks must keep in cash the less they will have to lend. But when the Federal Reserve simultaneously puts pegs under the government security market, the potentialities of credit expansion are not reduced, they are *increased.* Pegs, rigidly maintained, invite any and all holders of marketable government securities to turn their holdings into cash, for spending or lending, any time they please. Those holdings, outside the Federal Reserve Banks and Treasury investment accounts, run to $130 billion. This is the inflationary potential in a re-creation of pegs under the government market.

An Ironical Twist

The reinstatement of pegs for government securities is an ironical twist, after the long and arduous campaign that Federal Reserve officers have waged for a restoration of flexibility in the government bond market, and the reapplication of their powers to deal in that market on the statutory principles of "accommodating commerce and business and with regard for their bearing upon the general credit situation of the country."

It would be unfortunate if people should be led to believe that price and wage controls, or changes in bank reserve requirements, will save the dollar from serious depreciation. Neither program goes to the heart of the matter. There must be genuinely effective measures to restrict the supply of money competing for goods, higher taxes, and more saving and less spending for non-essential purposes both by government and by the people.

Excess Profits Tax of 1950

As we go to press Congress is about to complete action on its second revenue measure for meeting the rising cost of the defense program. The bill, which was introduced following the election recess and in its latest version combines a corporate excess profits tax with a slight rise in the regular corporation tax, has been rushed through Congress and at this writing awaits only House approval of the joint conference committee report ironing out House-Senate differences. It follows enactment in September of the Revenue Act of 1950, raising taxes on both individual and corporate incomes.

Haste on the part of Congress in pushing the new tax bill reflects an effort to meet the commitment in the September revenue act to bring in an excess profits tax measure before the expiration of the old Congress on January 2.

It will be recalled that the original plans of the Administration for new taxes to finance the expanded arms program contemplated immediate action only in raising individual and corporate income taxes, to be followed after the first of the year by request for additional taxes, including an excess profits tax. Though President Truman made clear that he favored an excess profits tax, he opposed including it in the interim bill for two reasons — (1) the introduction of so controversial a measure would probably hold up the bill and prevent the Treasury from getting an early start in collecting more revenue, and (2) the desirability of giving Congress more time to study this highly complicated subject and thus avoid serious inequities.

However, promise of excess profits tax action "after the first of the year" was not enough to satisfy an election-conscious Congress, aware of the political appeal of an excess profits tax. As one Congressman expressed it on the eve of the election recess, "If we tell the folks back home we voted for an increase in personal and corporation income taxes and didn't vote for an excess profits tax, well, someone is liable to have an issue there." Hence, even though the Senate version of the interim bill directed the tax-writing committees of both Chambers to include an excess profits tax, retroactive to July 1 or October 1, 1950, in the revenue measure scheduled for consideration early in 1951, nevertheless the House insisted on the amendment calling for introduction of an excess profits tax upon the reconvening of Congress after the elections, with a view to its enactment before the end of the session.

Accordingly, both tax committees have been working overtime to meet this schedule. Because of the determination of Congress to make a pre-election gesture, the bill has had to be rammed through with far less opportunity for study and debate than should accompany so complex and important a piece of legislation. Senator George, chairman of the Senate taxing committee, conceded that since it had been written "under extreme pressure", the measure prob-

ably contained errors that would have to be corrected in the next tax bill. He added that a perfect excess profits tax "is not, never has been, and never will be."

Terms of the Bill

The bill is calculated to yield $3.3 billion in a full year of operations upon corporate earnings at the level existing in calendar 1950. It imposes a tax at the rate of 77 per cent on that portion of corporate income over the excess profits tax "credit" as defined in the law; remaining income is subject to the regular corporate normal tax and surtax which together amount to 42 per cent for 1950 (45 per cent for 1951) and have been raised in the pending bill to 47 per cent. An overall tax ceiling on the three taxes combined is set at 62 per cent.

In World War II the comparative tax rate on excess profits was 95 per cent gross or 85.5 per cent after the postwar refund (10 per cent of the tax), while the normal tax and surtax totaled 40 per cent, and the overall ceiling was 80 per cent before the postwar refund of excess profits tax.

In computing the excess profits tax "credit" or amount of income exempt from excess profits tax, and subject to only the normal tax and surtax, the corporation is given a choice to use either "average earnings" or "invested capital." If the first method is used, the average earnings of the three best years of the four-year period 1946-49 are taken, and 85 per cent of this average is allowed as the credit. During World War II the average of the four years 1936-39 was taken, and 95 per cent allowed as the credit.

If the "invested capital" method is used, the credit is based upon a rate of return (before regular income taxes) on equity capital and retained earnings, set at 12 per cent on the first $5 million of invested capital, and graduated downward to 10 per cent on capital of $5-10 million and 8 per cent on that over $10 million. This scale compares with rates (before taxes) during the war ranging from 8 down to 5 per cent. In the new law there is more ample provision than in the former for additional credit based on the amount of borrowed capital. Regardless of which method is chosen, there is a minimum credit of $25,000.

The effective date of the excess profits tax is made retroactive to July 1, 1950. The increase of two percentage points, from 45 to 47, in the combined normal tax and surtax rate becomes effective January 1, 1951, but is retroactive in the case of companies whose fiscal years started on or after July 1, 1950.

Aside from these main features, the bill contains a great many special provisions applying to particular groups of companies and designed to relieve undue hardship, including new companies and those that have grown rapidly during the base period, companies that have increased greatly their physical capacity, companies whose industries were depressed during the base period, railroad and public utility companies subject to government regulation, banks, mining companies and others.

Good and Bad Features

The bill was passed despite the opposition of business generally, which did not expect to escape heavy taxation but objected to the many bad features of an excess profits tax and preferred a straight increase in the regular corporation income tax that would produce as much or more revenue. Even many business concerns which would not be hit by an excess profits tax expressed preference for a straight corporation income tax increase as a matter of principle.

It is fair to say the Congressional Committees made an earnest effort to avoid the worst features of an excess profits tax. The terms of the bill, the methods of computation, and the percentage rates of tax all focus the incidence more upon excess profits than was true in the World War II law and in the Treasury proposals. Throughout the course of hearings and debate on this bill, one special provision after another was added in order to eliminate or at least alleviate obvious inequities and hardships that were pointed out by different business groups.

However, many of these special provisions in the bill, which in the Senate print runs to 305 pages, are so complicated and ambiguous as to make their practical application uncertain and costly. These special relief provisions, though essential if we must have an excess profits tax at all, have the effect not only of making the law infinitely complex, but also of reducing the yield. This in turn made it necessary to raise the rates of regular income tax to obtain the desired revenue. Thus in the end Congress had to compromise between the politically popular principle of an excess profits tax and the more practical across-the-board increase advocated by business.

The bill in its latest form still defines as "excess profits," subject to the top rate, 15 per cent of the earnings in the base period 1946-49 – long before Korea and the new defense program. On the other hand, the impact is softened by the 62 per cent overall tax ceiling, compared with the wartime ceiling of 80 per cent before postwar refund. With the impossibility of granting

specific relief in all necessary cases, this ceiling affords protection for those companies whose earnings, because of special circumstances, might almost all be classed as "excess."

In the rates allowed on invested capital, the bill is somewhat more liberal than the law in World War II. The new rates, however, of 12 down to 8 per cent before taxes, represent, after the 47 per cent normal tax and surtax, a return of only 6.3 down to 4.2 per cent. In the case of utilities and railroads, Congress recognized the sound principle that earnings of 6 or 7 per cent *after* taxes were necessary to assure progress and solvency. The question raised here is whether every business does not require at least as good a return.

In short, this provision admits a principle that is not followed in the rest of the bill. The larger banks, for example, get only 8 per cent before taxes, and a little over 4 per cent after taxes, which isn't enough to pay reasonable dividends and accumulate capital.

Where Additional Taxes Should Fall

With the enactment of the excess profits tax virtually completed, attention now turns to the next step in raising the funds required to meet the soaring defense costs. Only within the past few days a White House statement has reiterated the warning that "a much broader and expanded tax program will be necessary to meet the heavy cost of the defense program in the calendar year 1951 and subsequently."

The question is, where is this money coming from? In the steps already taken Congress has tightened the screws on individual and corporate incomes to the extent of $7.8 billion. At the new rates the individual income tax is going to hurt all up and down the income scale. At the same time corporation taxes have been lifted to levels where, unless they are passed on in the form of higher prices, they seriously endanger progress.

At this point it is important to keep in mind the central principle that what we need to do in the present situation is to encourage production and discourage spending. Hence we should tax consumption and not production. Taxing spending will encourage saving. This is a strong argument for more excise taxes rather than more income taxes—corporate or individual.

Last month the House majority leader, John McCormack, suggested a general manufacturers' excise tax. He declared that:

> Individual income taxes already are high. Corporation taxes are getting higher. We are about to enact an excess profits tax to prevent inflation and recapture in part the large profit derived from emergency expenditures.
>
> A general manufacturers' excise tax is the only remaining where large revenue can be obtained.

Other suggestions have been for a general retail sales tax.

Excise and sales taxes meet the objective of the "much broader and expanded" program mentioned in the White House statement by taxing the large portion of total personal income not reached by individual and corporate income taxes. In the report of the Senate Finance Committee on the Revenue Act of 1950, it was estimated that the number of taxable returns would be approximately 38,000,000 or only about 63 per cent of the 60,000,000 people gainfully occupied. The net income reported on these returns, estimated at $131 billion, was only 58 per cent of the total personal income of some $225 billion. Moreover, a large portion of the income reported on the tax returns is in the lower brackets and thus subject to relatively light taxes because of personal exemptions. Admittedly also, a certain amount of income by one means or another avoids the income tax. An excise tax is the only way of tapping the large share of income that is either exempt or is not reported.

The old argument against excise taxes on the ground that they are "regressive," falling heaviest on the low income groups, carries much less weight today because of the fact that the rise in incomes generally during the past ten years or more has been sharpest in the low income groups. According to a recent study by the National Industrial Conference Board, the weekly pay check of a married factory worker with two children commands 27 per cent more goods and services than it did in January 1941, in spite of higher taxes and the postwar rise in cost of living. The weekly wages do not include longer paid vacations and higher pensions which place factory workers in a more advantageous position than at any previous time, the Board noted.

In many ways excise taxes which exempt basic necessities are less severe than income taxes in that they give each recipient some choice as to whether he will spend or save, and do not tax that portion of income that is saved.

One thing is certain—that to raise the huge sums required everybody will have to make some contribution. As Senator Eugene D. Millikin, although voting in favor of the excess profits tax, declared, "There is an awful lot of fakery about this tax. People are given the impression that if we get this from the big, pot-bellied corporations then most of the people won't have to pay any more taxes."

Condensed Statements of Condition

THE NATIONAL CITY BANK OF NEW YORK

***Head Office:* 55 Wall Street, New York**

67 Branches in Greater New York **52 Branches Overseas**

ASSETS

	Dec. 31, 1950	*Dec. 31, 1949*
Cash, Gold and Due from Banks	$1,437,981,108	$1,264,319,880
United States Government Obligations	1,724,232,775	1,902,584,206
Obligations of Other Federal Agencies	60,599,854	33,038,025
State and Municipal Securities	426,364,539	315,078,023
Other Securities	137,186,350	90,859,706
Loans and Discounts	1,664,941,944	1,381,156,840
Real Estate Loans and Securities	6,422,939	560,011
Customers' Liability for Acceptances	15,819,426	19,194,542
Stock in Federal Reserve Bank	7,800,000	7,500,000
Ownership of International Banking Corporation	7,000,000	7,000,000
Bank Premises	26,970,778	27,021,458
Items in Transit with Branches	8,657,198	—0—
Other Assets	2,371,117	3,675,648
Total	$5,526,348,028	$5,051,988,339

LIABILITIES

Deposits	$5,130,853,626	$4,669,251,863
Liability on Acceptances and Bills. *(Own Acceptances in Portfolio Deducted 1950—$15,316,547; 1949—$6,559,133)*	19,532,918	22,960,969
Items in Transit with Branches	—0—	13,472,380
Due to Foreign Central Banks *(In Foreign Currencies)*	12,989,000	9,527,700
Reserves for:		
Unearned Discount and Other Unearned Income	11,562,252	8,053,790
Interest, Taxes, Other Accrued Expenses, etc.	30,699,406	25,778,521
Dividend	2,635,000	2,480,000
Capital *(6,200,000 Shares—$20 Par)*	124,000,000	124,000,000
Surplus	136,000,000	126,000,000
Undivided Profits	58,075,826	50,463,116
Total	$5,526,348,028	$5,051,988,339

Figures of Overseas Branches are as of December 23.

For 1950, $283,763,467 ($303,564,822 in 1949) of United States Government Obligations and $15,014,100 ($7,665,500 in 1949) of other assets are deposited to secure $208,701,191 ($220,807,891 in 1949) of Public and Trust Deposits and for other purposes required or permitted by law.

(MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION)

CITY BANK FARMERS TRUST COMPANY

***Head Office:* 22 William Street, New York**

Affiliate of The National City Bank of New York for separate administration of trust functions

ASSETS

	Dec. 31, 1950	*Dec. 31, 1949*
Cash and Due from Banks	$ 41,131,215	$ 43,740,244
United States Government Obligations	81,616,668	84,171,023
Obligations of Other Federal Agencies	1,846,782	1,550,958
State and Municipal Securities	12,074,089	7,473,628
Other Securities	3,393,501	101,038
Loans and Advances	1,395,376	1,107,449
Real Estate Loans and Securities	1	1,105,978
Stock in Federal Reserve Bank	600,000	600,000
Bank Premises	2,819,012	2,923,162
Other Assets	2,590,848	2,453,448
Total	$147,467,492	$145,226,928

LIABILITIES

Deposits	$113,331,634	$111,945,613
Reserves *(Includes Reserve for Dividend 1950—$155,295; 1949—$310,590)*	3,480,928	3,248,072
Capital	10,000,000	10,000,000
Surplus	10,000,000	10,000,000
Undivided Profits	10,654,930	10,033,243
Total	$147,467,492	$145,226,928

For 1950, $11,898,528 ($7,802,829 in 1949) of United States Government Obligations are deposited to secure $3,446,921 ($1,604,832 in 1949) of Public Deposits and for other purposes required or permitted by law.

(MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION)

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